

Sales of canned computer software are taxable sales in Illinois. See Section 130.1935. (This is a GIL.)

February 10, 2006

Dear Xxxxx:

This letter is in response to your letter dated April 18, 2005, in which you request information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

The purpose of this letter is to request binding sales and use tax opinion.

Background

ABC is currently a leader in high-performance, high density, programmable logic devices (PLDs) and associated computer-aided engineering logic development tools. PLDs are semiconductor chips that can be customized and programmed by the customer using software tools that run on personal computers or engineering workstations. ABC develops, manufactures, and sells high-density, microchips, PLDs, related hardware, software and intellectual property cores for use in designing the PLDs. ABC is headquartered in CITY/STATE. ABC's primary customers are distributors. ABC anticipates future increases in direct sales to manufacturers of consumer electronics and communications devices.

Facts

ABC and customer enter into a contract for ABC to develop a previously un-marketed structured-application-specific-integrated-circuit (ASIC) microchip utilizing customer supplied files on an ABC base array. ABC refers to the processes outlined in this request collectively as "NAME". The new device is a combination of the customer's data files (microcircuits) and ABC data files (microcircuits). Customers utilize ABC software tools to design their microcircuits in a computer environment. Customers have the option of incorporating pre-designed "modules" contained in the software tools in their chip design for a one time royalty fee. The pre-designed modules contain microchip

circuitry used to perform common routines such as clock or calculation functions. Software tools are delivered via electronic transmission and may require the use of a dongle or hard token. Dongles or hard tokens are included in the selling price of the software tools when required for tools operation. ABC provides one time non-recurring engineering services (NRE) to merge/graft the customer's electronic design files with the existing ABC base array files in a computer environment. Successful technology pairings are migrated to a standard ABC base array (microchip). A successful project will result in a newly created process as evidenced by a device that is distinctive in nature. The final ASIC device will have unique functions, highly specialized performance characteristics, and satisfy a previously unfilled customer need. The NRE for the design and development is performed in a computer environment. Photo-masks are prepared for the newly created device by a third party manufacturer off shore. The masks remain the property of ABC and reside offshore.

Upon satisfactory development, fabrication, and testing the customer is provided functional prototypes for evaluation and confirmation of successful design. The prototypes are not intended for functional use or resale. The customer uses the prototypes solely to test and evaluate the design characteristics. Customers communicate approval/acceptance of design concept using the NAME Prototype acceptance form.

In general, customers have six (6) months from concept approval date to take delivery of an agreed upon minimum order quantity (MOQ). Subsequent production purchases of approved designs are generally under a separate purchase order. Customers may cancel or reschedule a production order with proper notice. Penalties are charged for untimely cancellations of the NRE contract for cost recovery based on agreed upon terms in the contract. ABC's design, development, and production of NAME devices is not contractually deemed a "work for hire". ABC does not assign or transfer any intellectual property rights to the customer, other than the right to use the NAME devices in customer's target systems.

There is a high degree of uncertainty whether the customer's technology (microcircuits) can be successfully mated with ABC's technology and function harmoniously on a standardized base array. The true object of the NAME service is the creation of a new device that meets customers' parameters and requirements, and is reproducible in quantity. Substantially all of the activities performed in the design processes will involve some degree of uncertainty. Intensive and specialized testing is required at each phase of development.

We respectfully request a binding opinion on the proper sales/use tax treatment for the transactions below.

Questions

1. Are charges for NAME services to design a new ASIC device subject to sales tax?
2. Are the initial prototypes given at no charge subject to sales or use tax?
 - a. If so, what is the measure of tax?
3. Are subsequent sales of prototypes subject to sales or use tax?
 - a. If additional prototypes sold are to be used for further testing and evaluation?
 - b. If additional prototypes are to be consumed by the customer?

- c. If additional prototypes are to be resold by the customer?
4. Are charges for software tools used by customers to design their micro circuitry in an ABC preferred format subject to sales tax?
 - a. If delivered in tangible form (CD/Disk)?
 - b. If delivered electronically via email or download?
 - c. If delivered intangibly with a tangible dongle or hard token?
5. Are production units sold under the minimum order quantity requirement subject to sales tax?
6. Are cancellation charges associated with early termination of an NRE contract subject to sales or use tax?
 - a. If so, what is the measure of tax?
7. Are cancellation charges associated with early termination of the minimum order quantity requirements for production units subject to sales or use tax?
 - a. If so, what is the measure of tax?
8. Are the one time royalty charges for intellectual property cores (prewritten sub-routines/circuitry contained in the software tools) incorporated by customers into the new ASIC microchip subject to tax?

Please do not hesitate to contact me via the email address below, should you have any questions or require additional information.

DEPARTMENT'S RESPONSE:

The Department of Revenue is declining the issuance of a private letter ruling based on the limited information provided regarding the production of the complex technical devices described in your letter. In order to consider a private letter ruling, we would need to examine the contracts detailing each parties' rights and duties, and be provided with a greater explanation of the actual transactions. I hope the following general information will be helpful.

The issue of whether a person incurs a Retailers' Occupation Tax or Service Occupation Tax liability depends upon the nature of the items being produced and the nature of the design work involved. If the item being produced is substantially similar to stock or standard items, even though custom-made, the sale of that item would result in Retailers' Occupation Tax liability. Examples of such items are tailor-made clothing and draperies, etc. The test for special order items that result in Service Occupation Tax liability is set forth in subsection (b) of 86 Ill. Adm. Code 130.2115.

The seller of a special machine, tool, die, jig, pattern, gauge or other similar item is engaged primarily in a service occupation, rather than in the business of selling tangible personal property, and so does not incur Retailers' Occupation Tax liability with respect to the sale, if the following tests for exemption are all met in the transaction:

- A) The purchaser employs the seller primarily for his engineering or other scientific skill to design and produce the property on special order for the purchaser and to meet the particular needs of the purchaser;
- B) The property has use or value only for the specific purpose for which it is produced; and
- C) The property has use or value only to the purchaser. 86 Ill. Adm. Code 130.2115(b).

If a manufacturer is employed to provide engineering or other scientific skill to design and produce tangible personal property on special order for the purchaser in order to meet the particular needs of the purchaser, and that tangible personal property has no value to others than the purchaser for the purpose for which it is produced, then the manufacturer will incur Service Occupation Tax liability on the sale of that customized tangible personal property, rather than Retailers' Occupation Tax liability.

Please note that if such a manufacturer constructs and sells 50 or more identical property items in a single order or in multiple orders, those sales will be deemed to be volume production and will be subject to Retailers' Occupation Tax (rather than Service Occupation Tax) liability based on the total amount received by the manufacturer from such volume production multiple order or orders. See subsection (a)(4) of Section 130.2115.

Under the Service Occupation Tax Act, 35 ILCS 115/1 et seq., servicemen are taxed on tangible personal property transferred as an incident of the sale of service. Purchases of tangible personal property that is transferred to the service customer may result in either Service Occupation Tax or Use Tax liability for the serviceman, depending upon which tax base the serviceman chooses to calculate his liability. Servicemen may calculate the tax base in one of four ways: (1) separately stated selling price; (2) 50% of the serviceman's entire bill; (3) Service Occupation Tax on the serviceman's cost price if the serviceman is a registered de minimis serviceman; or (4) Use Tax on the Serviceman's cost price if the serviceman is de minimis and is not otherwise required to be registered under the Retailers' Occupation Tax Act, 35 ILCS 120/1 et seq. See 86 Ill. Adm. Code 140.101 through 109.

In your request, you mention prototypes that you give away. We are unable to determine from the information provided whether this is the result of a contractual obligation or whether it is what the Department considers a true gift situation. When property is purchased and then given away, the donor has made a taxable use of the property by making such gift. Therefore, it is the donor of the gift who is deemed the end user of the property and who is subject to the Use Tax, rather than the donee. See 86 Ill. Adm. Code Section 150.305(c).

The donor's Use Tax liability is calculated on the cost price of the property given away. When the property is purchased at retail, the base for calculating Use Tax is the purchase price of the property. If, however, the property given away is a finished product produced by the donor, the donor's Use Tax liability is calculated on the donor's cost price of the materials and products purchased and incorporated into the finished product. See 86 Ill. Adm. Code Section 150.305(b) and (c).

Generally, sales of "canned" computer software are taxable retail sales in Illinois. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See Section 130.1935(c). Custom computer programs or software are prepared to the special order of the customer. The selection of pre-written or canned programs assembled by vendors into software packages does not constitute custom software unless real and substantial changes are made to the programs or creation of program interfacing logic. See Section 130.1935(c)(3). Canned software is considered to be tangible personal property regardless of the form in which it is transferred or transmitted, including tape, disc, card, electronic means or other media. For a detailed review of the tax liability for computer software, please see 86 Ill. Adm. Code 130.1935.

You have asked about cancellation and royalty fees. In general, cancellation and royalty fees that are not consideration for the sale of tangible personal property are not subject to Retailers'

Occupation Tax. Royalty fees and cancellation charges would be considered gross receipts subject to tax if tangible personal property were transferred to the customer.

I hope this information is helpful. If you require additional information, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336. If you are not under audit and you wish to obtain a binding PLR regarding your factual situation, please submit a request conforming to the requirements of 2 Ill. Adm. Code 1200.110 (b).

Very truly yours,

Edwin E. Boggess
Associate Counsel

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